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Restricting preferential tax regimes to avoid harmful tax competition

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Abstract

Governments fear that tax competition erodes national revenues. Preferential tax regimes, which levy different taxes on distinguishable tax bases, are particularly criticized for accelerating a race to the bottom. According to both the EU and the OECD, countries should refrain from this kind of tax discrimination. This viewpoint was recently queried by [Keen, M., 2001. Preferential regimes can make tax competition less harmful. National Tax Journal 54, 757–762]. He argues that preferential regimes soften interjurisdictional competition. The present paper, by contrast, defends the original objections to preferential treatments. If investors have a home bias (which is in line with empirical evidence), moderate restrictions on preferential regimes always increase equilibrium revenues. Moreover, we present sufficient conditions under which a total ban on preferential treatments is optimal from the governments' perspectives.
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1. Motivation

In the era of globalization, regional markets have become increasingly integrated into a single world market. Dismantling barriers to the international movement of production factors has enhanced particularly the mobility of capital. This development intensifies not

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only the rivalry between firms. It also fosters competition between countries, since capital, as a major component of regional tax bases, responds more and more sensitively to international tax differentials. As a consequence, a substantial proportion of international investment flows to low-tax countries. The keen, emerging interjurisdictional competition pushes down the public burden on mobile bases. Whether this is good or bad is open to dispute. On the one hand, tax competition seems to be a good firewall against governments' biases towards increasing their budgets beyond efficient levels. On the other hand, it might restrict the governments' ability to finance 'beneficial' public expenditures.[1]

Recent political strategies can be interpreted as a compromise between the two extreme positions. The EU and OECD aim at restricting so-called 'harmful' tax practices without attempting to eliminate tax competition totally. This policy intends to prevent a ruinous race to the bottom which drastically erodes national revenues. In this context, the OECD (2000) identified 47 'harmful' regimes and 35 jurisdictions operating as tax havens, and the EU's Code of Conduct Group (2000) listed scores of regulations with 'harmful features' that had been implemented in EU member countries. According to both the OECD (1998) and the Council of the European Union (1998), applying different tax rates to residents and non-residents and ring-fencing national tax bases by other means are key indicators of undesirable measures.[2] In line with the previous literature, we refer to these practices as preferential tax regimes.

It is important to notice that preferred treatment of foreign residents is often granted indirectly rather than directly. Take the famous case of Ireland which only levied a 10% tax rate on corporate income in the manufacturing and financial services sectors instead of the standard rate (32%).[3] On the surface, this measure was discrimination between sectors. In fact, it was largely for the benefit of foreign investors, who were major players in the low-tax sectors. We think it is fair to say that this discrimination induced in favor of investments of non-residents was intentional. As a consequence of this preferential treatment, huge amounts of foreign investments were attracted to Ireland and became a main factor in the rapid growth of GDP in the nineties. Since Ireland 'ring-fenced' its domestic tax base to a high degree, it raised its total base without risking drops in its tax revenues stemming from economic activities of domestic investors.

[1] Both stances are widespread among economists. Most papers on tax competition support the notion that interjurisdictional competition leads to inefficiently low tax rates (see, for instance, the early contribution of Wildasin, 1989). A comprehensive survey of this literature is provided by Wilson (1999). The idea that tax competition corrects the oversized public sector is largely based on the seminal contribution of Brennan and Buchanan (1980). According to their line of reasoning, government expenditures tend to reach too high a level as a result of political failure. These very different evaluations of competition among governments is in striking contrast to the broad consensus that competition between private agents is, in principle, welfare enhancing. See the discussion in Oates (2001).

[2] A comprehensive guideline on the features of 'harmful' tax regimes is given in OECD (1998) and Council of the European Union (1998).

[3] Ireland implemented a variety of measures to give these preferential treatments. For instance, companies engaged in financial services activities and located in the Shannon Airport Zone or the International Financial Services Centre in Dublin could qualify for these tax benefits. See Code of Conduct Group (2000) for details.

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